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IN THE

Supreme Court of the United States

INTEGRATED TELECOM EXPRESS, INC. AND THE OFFICIAL COMMITTEE OF EQUITY SECURITY HOLDERS,

Petitioners,

v.

NMSBPCSLDHB, L.P.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF

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RULE 29.6 STATEMENT

Petitioners' corporate disclosure statement was set forth at page *ii* of the Petition for a Writ of Certiorari, and there are no amendments to that statement.

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INTRODUCTION

The issue presented in *In re Integrated Telecom Express* ("*Integrated*") is not whether a single debtor possessed bad faith in filing its chapter 11 petition nor is its effect limited to discrete, unique facts of an isolated case. Instead, the issue presented is broad: whether the Bankruptcy Code serves the interests of *creditors alone*, or whether the Bankruptcy Code also serves the interests of equity and other non-creditor constituents as well.

Integrated does not, as Respondent suggests, reflect "the application of a well-settled doctrine to an extreme set of facts." Opp'n 6. Rather, the Third Circuit's application of the ambiguous, unsettled, and ever malleable common law test for "good faith" became a cipher under these issue-laden facts for its adoption of an extremely controversial creditor-centric view of the Bankruptcy Code, which (as Judges Ambro and Rendell warned) is certain to extend beyond the facts of this case and to pervade and color other courts' analysis of chapter 11 filings generally.[1] Review of this case is therefore merited, to once and for all determine whether the purposes of the Bankruptcy Code serve creditors alone, to the exclusion of equity and all other non-creditor parties in interest.

The decision below is important precedent, certain to have an expansive impact both on bankruptcy law as well

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1. Decisions of the Third Circuit affect bankruptcy law and general business affairs to a greater degree than decisions from its sister circuits because a majority of large, publicly held corporations are incorporated in the State of Delaware and the venue choice for many corporate reorganizations is the District of Delaware. *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987 (2002) (characterizing the District of Delaware as the "reorganization capital for large, publicly owned debtors"). If the Third Circuit's decision is left to stand, the creditor-centric view of the Bankruptcy Code is thus likely to become the *de facto* majority standard by virtue of this "marketplace" dynamic.

as economic affairs in general.[2] It is therefore well deserving of this Court's special scrutiny.

INTEGRATED CREATES A CLEAR CIRCUIT SPLIT

A. The Common Law Good Faith Filing Test Is Not "Settled" Because There is Pervasive Confusion Concerning the Underlying Policies of the Bankruptcy Code

Respondent suggests that the good faith filing test is "well[ ]settled" and disavows that there is any confusion among the circuits over the standard. Opp'n 9. Courts faced with applying good faith to the facts of a debtor's case have, however, been much less sanguine.[3] Courts have repeatedly criticized the doctrine's imprecision, describing it, for example, as "an amorphous gestalt, devoid of reasoning and impenetratable to understanding" and "a prime example of how courts should not formulate a rule of law." *In re Victoria Ltd. P'ship*, 187 B.R. 54, 61, 62 (Bankr. D. Mass. 1995).

Integrated has further exacerbated this impenetratable gestalt jungle. Although the Third Circuit used the usual talismanic phrase, "totality of circumstances," to describe its good faith test, it is the descriptions of the *purposes* of the Bankruptcy Code that are problematic, not the usual "totality" fact-based inquiry that assesses compliance with those polestar purposes.

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2. For just one example of how *Integrated's* creditor-centric doctrine is already infecting bankruptcy law in general see, *e.g.*, *Mirant Mid-Atlantic, LLC v. Morgantown OL1* LLC, No. 03-46590-DML-11, 2005 Bankr. LEXIS 619 (Bankr. N.D. Tex. April 7, 2005) (extending the doctrine and refusing to grant declaratory relief for recharacterization of claims, stating "[e]ven provisions of the Code which ... allow limitation of payment of creditor claims ... have been construed as limited to situations where the result is enhanced return to creditors").

3. Commentators have agreed: "[C]ourts have been all over the map in applying the 'teachings' of [the leading good faith precedents] *Marsh* and *SGL Carbon*." Robert J. Keach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, 23-10 AM. BANKR. INST. J. 36, 36 (2005) (particularly lamenting the disarray under a liquidating chapter 11).

Courts' grab-bag of explications of the purposes of bankruptcy as they relate to the good faith filing standard are so diverse they defy comprehension even with the aid of the most sophisticated attempts to flowchart the analysis.[4] *Integrated* itself is premised on a misreading of Supreme Court precedent, reading that precedent to limit use of chapter 11 to the maximization of creditor returns, rather than preservation or maximization of the value of non-creditor interests. The Third Circuit cited to *Bank of Am. Nat'l Trust & Savs. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 453 (1999), for this principle, suggesting that because the Supreme Court had there identified two of the basic purposes of chapter 11 as (1) preserving going concerns and (2) maximizing property available to satisfy *creditors*, these were the *sole* purposes of the Bankruptcy Code.[5]

But the Bankruptcy Code contains many provisions directed to the protection of equity, and other, interests.[6] Chapter 11, therefore, not only serves the interests of creditors, but also protects value for other constituents as well. *See CFTC v. Weintraub*, 471 U.S. 343, 354-56 (1985).

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4. One court has been reduced to stating the purposes of bankruptcy under the good faith filing test in terms of whether the debtor "*need[ed]* Chapter 11 relief." *In re Liberate Techs.*, 314 B.R. 206, 211 (Bankr. N.D. Cal. 2004) (emphasis added). A query: what is that supposed to mean?

5. *203 N. LaSalle*, of course, was about the conditions under which old equity could purchase new equity in an insolvent chapter 11 debtor. One commentator has noted that its use by the Third Circuit in this context was "ironic, at best." *See* Keach, *supra* note 3 at 73 n.72.

6. *See, e.g.*, 11 U.S.C. § 1102 (appointment of equity security-holders committee); § 1129(b)(2)(c) (definition of fair and equitable plan as to class of interests); § 1129(a)(8) (requirement of acceptance by impaired class of interests); § 1123(a)(4) (prevention of discrimination among interests); § 1123(a)(7) (protection of interests of equity security-holders).

B. *In re Sylmar Plaza* is "On All Fours" with *Integrated*

The Respondent attempts to trivialize the doctrinal circuit splits that are both highlighted and exacerbated by the decision below in this case. In particular, the Ninth Circuit's decision in *Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)*, 314 F.3d 1070 (9th Cir. 2002), starkly demonstrates the schism between courts that view the Bankruptcy Code as limited to the service of creditors, versus others that view the Bankruptcy Code to serve a broader universe of parties in interest.

The Respondent charges that our invocation of the circuit split between the Ninth and Third Circuits "misrepresents the facts and holding of *Sylmar Plaza*." Opp'n 7. We respectfully suggest that this bare rhetoric shuns deeper analysis of policy concerns. Respondent's charge also fails to accord the proper deference and respect to the two lower courts, who each found *Integrated* to be almost "on all fours" with *Sylmar Plaza*.

More important, either ignoring or not recognizing the policy schism between the two circuits, the Respondent fails to analyze the very issue of law it claims harmonizes the two cases. Echoing the Third Circuit, Respondent simply proclaims (without analysis) that in *Sylmar Plaza*, unlike in *Integrated*, the Bankruptcy Code "was used to maximize value *for creditors as a whole*." Opp'n 7 (emphasis added). This is a surprising assertion, for in *Sylmar*, which was clearly a strategic filing, there was essentially only one creditor, whose claim was capped to maximize value for equity interests. In fact, the only cognizable substantive difference between the debtors in *Sylmar Plaza* and *Integrated* was the particular section of the Bankruptcy Code utilized by the debtor to cap the creditor's claim.[7] No court below has suggested that this distinction was material.

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7. Respondent's attempt to distinguish the cases based on the fact that in *Integrated*, the "financially healthy Debtor's assets consisted of

(Cont'd)

The essential split between the *Integrated* court and the *Sylmar* court lay not in any applicable distinction in the underlying facts. Rather, the divergent holdings in *Sylmar* and *Integrated* are rooted in these courts' differing analyses of the essential policy question: whether a non-creditor may benefit at the expense of a creditor.

The *Sylmar* court's answer: Yes. The *Integrated* court's answer: No. *See* Pet. 23.

THE THIRD CIRCUIT IMPROPERLY FOCUSED ON ONLY HALF OF THE VALUE MAXIMIZATION EQUATION

The Debtor possessed a proper distributional purpose for its chapter 11 liquidation filing. The Respondent points instead to the Third Circuit's depiction of the Debtor's goals as *redistributive*: "[t]o be filed in good faith, a petition . . . must seek to create or preserve some value that would otherwise be lost—not merely distributed to a different stakeholder—outside of bankruptcy." Opp'n 14; App. A 41a.

However, the Third Circuit's contention that the Debtor's purpose for entering chapter 11 failed to be properly "distributive" does not appreciate that the value maximization equation, *i.e.*, the timing and amount of distributions, is a function of not only by how *assets* are "liquidated," but also by how *claims* are "liquidated." The Third Circuit errs when it defines value creation entirely with reference to the asset side of the value equation, rather than the *net value* that efficient claim liquidation creates.

(Cont'd)

cash that passed through the bankruptcy unchanged in value," also fails. Opp'n 8 n.2. Respondent's statement is factually incorrect. Integrated was a doomed business and its entire intellectual property portfolio (*i.e.*, previously Integrated's essential value and engine of profitability) was liquidated within the bankruptcy case at an increase in value over what a non-bankruptcy sale would have brought. *See* Pet. 5.

Although the Third Circuit seems to deem certain portions of the Bankruptcy Code less worthy than others (when used by solvent debtors),[8] § 502(b)(6) performs no mere "redistributional" function. Rather, the provision was expertly designed by Congress to maximize net value to the estate—operating on the liabilities side of the value equation—by avoiding the difficulty and expense to the debtor in liquidating (*i.e.*, litigating) a landlord's speculative claim, which Congress considered "contingent and difficult to prove." S. REP. NO. 95-989, at 64 (1978).

Although Respondent argues that "the Debtor's bankruptcy filing accomplished *nothing* other than frustrating the Landlord's claim," Opp'n 12, Congress has decided otherwise, that an equitable and economically beneficial policy is served and that value is maximized where the estate is spared the time and expense of litigating a contingent landlord's claim by resort to § 502(b)(6).[9]

The Third Circuit's mischaracterization of § 502(b)(6) as a mere "[re]distributional mechanism" reveals its rejection of the congressional policies behind § 502(b)(6). The Debtor possessed a proper threshold liquidation purpose, both in terms of its use of § 502(b)(6)—and otherwise.[10]

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8. The Third Circuit also minimized the Debtor's use of § 510(b), without which the trial court found the liquidation would have been "stalled" indefinitely by a $93 million shareholder class action claim "deemed allowed" under § 502(a). *See* App. A 14a.

9. By comparison, the *Integrated* decision did nothing to advance an orderly liquidation or enhance value. Instead, by dismissing the case, the court is forcing the creditors and equity holders to return to the "first come first serve" state court arena where the size of their claims and their rights in various assets are unclear and the likely competition will only further reduce the size of the assets available for distribution.

10. As detailed in the Petition, the trial court found that the Debtor had many other valid purposes for its filing.

INTEGRATED CREATES UNTENABLE UNCERTAINTY AND RISK FOR CORPORATE OFFICERS AND DIRECTORS

Integrated—and the irreconcilable split with the Ninth Circuit left in its wake—leaves corporate boards wondering when (if ever) solvent debtors can file in good faith and what they can (or must) do to discharge their fiduciary duties to creditors and shareholders.

Integrated failed to address the critical issue of fiduciary duty. Outside of bankruptcy, the management of an entity has a duty to preserve and maximize the value of the enterprise for the benefit of the holders of equity interests. When the entity becomes insolvent, this duty also extends to creditors. 7-1108 COLLIER ON BANKRUPTCY ¶1108.09 (15th ed. rev. 2005).

The same principles apply in bankruptcy. Unquestionably, the fiduciary duty of the corporate debtor in possession runs to the shareholders as well as the creditors. The debtor in possession must treat all claimants and interest-holders "fairly, equally and in accordance with the priority of their claims under law." *Bergquist v. Felland (In re O-Jay Foods Inc.)*, Nos. BKY. 3-89-281, ADV. 3-90-40, 1991 Bankr. LEXIS 2122, at *45 (Bankr. D. Minn. July 5, 1991).

As applied to the facts of this case, if liquidation in chapter 11 of this failed but balance-sheet solvent entity would maximize the return to interest holders by limiting the amount of (or subordinating) claims, didn't Integrated's board have a duty to its shareholders to pursue a liquidating chapter 11?[11] Once in chapter 11, wouldn't that same duty

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11. Both the Bankruptcy Court and the District Court noted that Integrated's board "had an obligation" to take the steps it did and would have breached its fiduciary duty to the investors had they not filed the chapter 11 petition. App. B 55a; App. C 71a.

then have required the use of provisions, such as § 502(b)(6) and § 510(b), to maximize the value of the estate? Viewed within this framework, the board's acts in filing the chapter 11 petition (as their fiduciary duty to shareholders required) cannot be deemed in bad faith. Such acts prompted by the reasoned business judgment of corporate fiduciaries did not remotely merit the dismissal of this case.[12]

Petitioners respectfully suggest, therefore, that the facts present in *Integrated* are not akin to "snow in August." Rather, they reflect the all-too-common dilemma faced by the officers and directors of an economically distressed entity, whose fiduciary responsibilities require them to be men and women "for all seasons."

This dilemma exactly illustrates the disturbing problem with the rule in *Integrated*. Because the Third Circuit's good-faith inquiry is so fact-intensive and laden with delphically ambiguous eligibility requirements,[13] few boards can ever know in advance if resorting to chapter 11 will run afoul of *Integrated's* novel test or, alternatively, whether failing to file for chapter 11 will breach the board's fiduciary obligations to shareholders. Such uncertainty in the law creates a perverse incentive for boards to wait to file until assets have been needlessly squandered into insolvency. Fear and uncertainty produce inaction and inertia by the officers and directors, and the entity, its owners, and ultimately, the marketplace suffer economic loss as a result.[14]

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12. Respondent appears to agree that the case of a liquidating debtor should only be dismissed for intentional fraud. Opp'n 11 (stating that good faith operates as a tool to circumvent any "petitioner's attempt to commit *fraud* upon the court" (quoting *Furness v. Lilienfield*, 35 B.R. 1006 (D. Md. 1983) (emphasis added)).

13. The Third Circuit's ruling that the Debtor failed to show any "pressure on the value of its assets that could be reduced or avoided in an orderly liquidation" is merely another way of saying the debtor must be insolvent in the cash flow sense. *Cf.* Opp'n 13 n.6.

14. The Respondent makes much over the board resolution. But the resolution was forged out of the exigencies of the Debtor's (Cont'd)

For these reasons, Congress chose to delete the good faith filing standard that had previously been contained in the Bankruptcy Act when it enacted the Bankruptcy Code in 1978.[15] Congress also declined to insert any good faith eligibility test for chapter 11 filings in sweeping amendments to the Bankruptcy Code under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. (2005).

(Cont'd)

deteriorating financial condition and resultant need for a quick settlement with the Landlord. As such, the resolution is not indicative of the entire universe of purposes that existed for the Debtor's bankruptcy filing. Respondent fails to mention that the Debtor's petition in bankruptcy actually followed months later, after a subsequent board resolution dated October 8, 2002 authorized the filing.

15. The recommendations of the 1973 Commission on Bankruptcy Laws of the United States, adopted jot-for-jot into the Bankruptcy Code, articulate the reasons: a requirement of good faith in the filing would lead to fruitless litigation with creditors early in the case and was harsh on a debtor who needed some time to implement a plan. *See* Kennedy & Smith, *Postconfirmation Issues: The Effects of Confirmation and Post Confirmation Proceedings*, 44 S.C.L. REV. 621, 732-733 n.409.

Congress's decision to eschew a good faith filing requirement persists today. Although perceived abuse of the bankruptcy system was the impetus for enactment of the 2005 amendments, Congress declined to add "good faith" to the list of causes for conversion or dismissal under 1112(b)(2) in the 2005 amendments. *See* S. 256, 109th Cong. § 442 (2005).

CONCLUSION

"A rule of law should be susceptible to clear statement so that the result of its application to particular facts can be predicted with reasonable certainty. The good faith filing doctrine fails this test miserably." *In re Victoria Ltd. P'ship*, 187 B.R. at 61-62 (citing Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175 (1989)).

The good faith filing standard is neither clear, nor precise, nor uniform among the circuits. Unfortunately, the hopelessly confused body of case law on good faith now operates as a *de facto* eligibility test for a chapter 11 bankruptcy filing—regardless of whether this is contrary to Congress's intent. The test of good faith as a prerequisite to a bankruptcy filing is therefore both a proper and fitting subject for this Court's judicious review.

Respectfully submitted,

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